

Internal Revenue Service  
**memorandum**

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Br2:PLBurquest-Fultz

date: OCT 17 1988

to: Kendall C. Jones, Special Trial Attorney  
Office of Associate Chief Counsel (Litigation) CC

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: T.C. Docket No. [REDACTED]

This is in response to your request for technical advice regarding characterization of gains and losses incurred by the [REDACTED] on financial interest rate futures transactions and short sales of Treasury notes. [REDACTED]

[REDACTED]. Finally, you have asked us to consider application of Financial Accounting Standards Board Statement No. 80 on "hedge accounting" for tax accounting purposes under the facts presented.

ISSUES

1. Whether gains and losses realized by [REDACTED] on financial interest rate futures transactions and short sales of Treasury notes are properly characterized as capital rather than ordinary in nature.

2. [REDACTED]

3. Whether it is permissible for [REDACTED] to report losses realized on financial interest rate futures transactions and short sales of Treasury notes for tax purposes in a manner consistent with its method of reporting such losses for financial accounting purposes.

CONCLUSIONS

1. Gains and losses from [REDACTED]'s financial interest rate futures transactions and short sales of Treasury notes are properly characterized as capital rather than ordinary in nature under the Supreme Court's analysis in Arkansas Best Corporation v. Commissioner, S. Ct. No. 86-751 (March 7, 1988).

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2. Because losses from these transactions are characterized as capital, they will be subject to the capital loss carryback and carryover rules of section 1212.

[REDACTED]

3. The "hedge accounting" method of reporting gains and losses that [REDACTED] uses for financial reporting purposes is not appropriate for tax purposes under the facts presented. We believe that sections 1001(c) and 165(a) provide clear statutory authority for the current deduction of losses and current inclusion of income when the financial interest rate futures transactions are closed.

#### FACTS

[REDACTED]

[REDACTED]. Mortgage purchases are financed principally via the issuance of [REDACTED] securities to investors. [REDACTED] earns income on the spread (interest margin) between interest earned on the mortgages it holds and interest paid on debt securities it issues.<sup>1</sup>

As mentioned above, [REDACTED] acquires its funds for purchasing mortgages by issuing debt securities. Interest rates for this debt are comparable to Treasury rates. Much of [REDACTED]'s debt is short-term, even though its assets (the mortgages) are long-term. Thus, its profitability (i.e., interest margin) is strongly affected by prevailing market rates. Mortgage portfolio assets earning fixed, lower-than-market rates of interest will yield a loss if [REDACTED] must refinance the portfolio on a short-term basis without a corresponding increase in interest income from the mortgages.

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<sup>1</sup> [REDACTED] also earns a significant amount of income from fees, such as mortgage purchase commitment fees, [REDACTED]

[REDACTED]

By late [REDACTED] and into the early [REDACTED], [REDACTED]'s interest margin became negative; it was paying more in interest than it was earning. At that time, [REDACTED]'s portfolio consisted primarily of low interest, fixed rate, [REDACTED] year mortgages, yielding [REDACTED] to [REDACTED] percent. Yet, its cost of funds, based on short-term rates, reflected double digit rates as high as [REDACTED] percent in [REDACTED]. [REDACTED]<sup>2</sup>

Beginning in [REDACTED], [REDACTED] initiated major changes to reverse the negative spread it was experiencing. Its efforts included shifting the emphasis away from outright loan purchases to [REDACTED]<sup>3</sup> programs; increasing fee income

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<sup>2</sup> See Chairman's Letter, [REDACTED]  
[REDACTED] Annual Report.

<sup>3</sup> The [REDACTED] program is described in [REDACTED]  
[REDACTED]'s [REDACTED] Annual Report as follows:

[REDACTED]

The trust referred to above, has been classified by the Service as a grantor trust in [REDACTED]. Accordingly, each [REDACTED] certificate holder is treated as the owner of an undivided interest in the entire trust and must take into account his/her proportionate share of income (mortgage interest, prepayment penalties, assumption fees and late payment charges) as well as [REDACTED]'s fees charged as trustee for the trust.

on mortgage purchase commitments;<sup>4</sup> purchasing adjustable rate mortgages; engaging in resale/refinance activity; exchanging newly issued [REDACTED] stock for outstanding [REDACTED] debt; and engaging in a hedging program to protect against adverse movement of short-term interest rates.

In [REDACTED], [REDACTED]'s hedging program consisted of engaging in futures transactions ("explicit hedges")<sup>5</sup> and engaging in anticipatory borrowings or forward sales ("implicit hedges").<sup>6</sup> The program was designed to insulate it from certain market interest rate fluctuations using futures, forwards, options and cash positions to manage its debt portfolio (and the continuous restructuring/refinancing thereof). Net losses from hedging transactions were reported on [REDACTED]'s returns in [REDACTED] and [REDACTED] at \$ [REDACTED] and \$ [REDACTED], respectively. In [REDACTED], [REDACTED] reported a net gain from hedging activity of \$ [REDACTED].

Hedging activity in [REDACTED] and [REDACTED] consisted primarily of either: (1) purchase or sale of interest rate futures contracts, or (2) short sales of U.S. Treasury notes. The interest rate futures contracts activity engaged in by [REDACTED] consisted of establishing a short (sell) position on a futures exchange in contracts having a weighted average duration approximately equal to a planned debt offering. The short futures position would fluctuate in value inversely to the price of the commodity (financial instrument). In other words, a short position in Treasury bills futures at [REDACTED]% would increase in value if Treasury bill interest rate declined below [REDACTED]% and would decrease in value if the interest rate rose above [REDACTED]%. On or before the date of the public debt offering, [REDACTED] would close out its short position and realize gain or loss.

[REDACTED]'s short sale hedging activity operated by engaging a dealer to sell to a third party a face amount of Treasury notes in an amount approximately equal to the face amount of a planned debt offering at the current market price plus accrued interest. Because [REDACTED] did not yet own the

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<sup>4</sup> Commitment fee income increased from \$ [REDACTED] in [REDACTED] to \$ [REDACTED] in [REDACTED]. See [REDACTED] Annual Report, p. 2.

<sup>5</sup> The terms "implicit hedging" and "explicit hedging" were used in an article entitled [REDACTED].

<sup>6</sup> Forward commitments are offered to lenders who in turn become obligated to deliver loans at stated yields greater than the interest rate associated with anticipated borrowings.

notes sold, the dealer would borrow the Treasury notes, sell them, and hold the proceeds as collateral. [REDACTED] would then pay interest at the coupon rate of the notes to the dealer, who would in turn, pay interest (presumably at the same rate) to the lender. The dealer paid interest to [REDACTED] on the sale proceeds from the date of the initial sale to the date of the dealer's repurchase of the Treasury notes on the date of [REDACTED]'s debt offering. The interest paid to [REDACTED] by the dealer was less than the coupon rate, resulting in dealer profit from the transaction. If interest rates rose between the sale of the Treasury notes and [REDACTED]'s debt offering, [REDACTED] would realize a gain from the short sale, because the market value of Treasury notes purchased would be less than the price at which they were previously sold by the dealer. This gain would theoretically offset the increased interest costs of the debt offering between the time the offering was anticipated and the date it was actually consummated. If interest rates declined, [REDACTED] would be required to purchase the replacement Treasury notes at a market premium to satisfy the terms of the short sale arrangement with the dealer. Under this scenario, it would recognize a loss on the short sale, but would benefit from a decreased interest rate on its debt offering.

Losses sustained by the futures and short sales activity engaged in [REDACTED] and [REDACTED] were counted in [REDACTED]'s net operating losses for those years and were carried back to [REDACTED] and [REDACTED].

[REDACTED] contends<sup>7</sup> that because its hedging activities are integrally related to the acquisition of mortgages, gains and losses from futures and short sales activity are ordinary because the mortgages are "stock in trade" and thereby are excepted from the definition of the term "capital asset" in section 1221(1). It has not asserted that the futures contracts meet the definition of "hedging" contained in section 1256(e) and thereby fall into a perceived exception to the capital asset definition; we believe this issue has not been raised because Fannie Mae did not "identify" its contracts as "section 1256(e) hedges." [REDACTED]

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<sup>7</sup> [REDACTED]'s position on the issues set forth above is contained in a document entitled "Supplemental Protest Against Proposed Federal Income Tax Adjustments for Calendar Years [REDACTED] and [REDACTED]," (hereinafter, Supplemental Protest), dated [REDACTED].

LAW AND DISCUSSION

Issue 1: Whether the gains and losses realized in [REDACTED]'s futures and short sales activity are characterized as capital or ordinary.

Futures Transactions:

Section 1221 defines the term "capital asset" to mean all "property held by the taxpayer (whether or not connected with his trade or business)" unless specifically excluded. Exclusions include inventory-like assets, depreciable property, real estate used in a trade or business, property created by the personal efforts of a taxpayer, accounts or notes receivable (for services rendered or property transferred) acquired in the ordinary course of business, and U.S. Government publications received other than by purchase at the price offered to the general public. Certain other sections of the Code characterize gain or loss from disposition of property as ordinary by treating it as gain or loss from the sale or disposition of a noncapital asset. For example, section 1244 characterizes loss on the disposition of certain small business corporation stock as ordinary; section 582(c) characterizes as ordinary the gains and losses of certain financial institutions on the sale or exchange of nonqualifying bonds, debentures, notes, certificates, or other evidences of indebtedness.<sup>8</sup> There is no explicit statutory exclusion from the definition of the term "capital asset" for financial interest rate futures transactions engaged in by [REDACTED].

Judicial interpretation of the definition of capital assets contained in section 1221 was recently clarified by the United States Supreme Court in Arkansas Best Corp. v. Commissioner, S. Ct. No. 86-751 (March 7, 1988), which repudiates the so-called "Corn Products doctrine," that has developed over thirty years following the Supreme Court's opinion in Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955). Under that doctrine, the purpose for which an asset was acquired and held was determinative of its tax characterization. In Arkansas Best, the Court rejected post-Corn Products case law finding ordinary characterization simply because an asset was acquired for a business purpose. In this regard, the Court stated:

Petitioner argues that by focusing attention on whether the asset was acquired and sold as an integral part of the taxpayer's everyday business

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<sup>8</sup> The definition of "financial institution" to which section 582 is applicable does not include [REDACTED].

operations, the Court in Corn Products intended to create a general exemption from capital asset status for assets acquired for business purposes. We believe petitioner misunderstands the relevance of the Court's inquiry. A business connection, although irrelevant to the initial determination of whether an item is a capital asset, is relevant to determining the applicability of certain of the statutory exceptions, including the inventory exception. The close connection between the futures transactions and the taxpayer's business in Corn Products was crucial to whether the corn futures could be considered surrogates for the stored inventory of raw corn. For if the futures dealings were not part of the company's inventory-purchase system and instead amounted simply to speculation in corn futures, they could not be considered substitutes for the company's corn inventory, and would fall outside even a broad reading of the inventory exclusion.

Slip op. at 9.

From the above excerpt, the relationship of futures contracts to [REDACTED]'s trade or business is relevant to its characterization only for purposes of determining whether the contracts are substitutes or surrogates for inventory and thereby fall within the inventory exception of section 1221(1). [REDACTED]'s Supplemental Protest states that because [REDACTED]'s business is the purchase and sale of mortgages, these mortgages constitute section 1221(1) assets. Although we would agree that [REDACTED]'s mortgages are ordinary income assets, we believe the characterization derives from the agreed upon characterization ([REDACTED]) between the Service and [REDACTED]. No specific authority was given for this characterization; however, it has been followed in subsequent Revenue Rulings. [REDACTED]. We believe the purpose of this characterization is to equate the treatment of [REDACTED]'s sale of mortgages with the treatment of commercial banks and savings and loans that may also sell purchased mortgages.

Beginning in [REDACTED], commercial banks, savings and loans, and certain other financial institutions were required to recognize ordinary income or loss on sales of mortgages pursuant to section 582(c). Before that date, the Service characterized mortgages sales by banks that regularly engaged in such sales as "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" under section 1221(1). Rev. Rul. 60-346, 1960-2 C.B. 217. Accordingly, we conclude that even though section 582(c) does not apply to

██████████, mortgages sold in the ordinary course of its business (██████████) are section 1221(1) assets to ██████████ under the analysis applicable to banks contained in Rev. Rul. 60-346. However, our conclusion on this point is irrelevant to the characterization of the futures contracts in question because those contracts are not within the enumerated exceptions to the definition of the term "capital asset" under section 1221 and cannot be considered to be substitutes or surrogates for the mortgages.<sup>9</sup> Therefore, the contracts would meet the literal terms of the capital asset definition contained in section 1221 as construed by the Supreme Court in Arkansas Best, and are not excepted from capital asset treatment by any other Code section.

Our conclusion that the futures contracts themselves must meet the exception contained in section 1221(1) to be considered noncapital assets is also supported by the analysis contained in ██████████ GCM 38178, I-33-79 (Nov. 27, 1979), wherein it was stated with respect to a real estate investment trust (REIT) that engages in futures transactions to hedge against fluctuations in interest rates affecting its mortgage portfolio:

However, even if the mortgages loans constitute section 1221(1) assets under the rationale of Rev. Rul. 60-346 and Estate of Gutman v. Commissioner, the futures would nonetheless not constitute section 1221(1) assets despite the fact that they were purchased for hedging. It is our view that the Service has interpreted Corn Products Refining Co. v. Commissioner as holding that the futures acquired in hedging are not capital assets because they fall within a judicial exception to section 1221 rather than because the futures are property described in section 1221(1). Otherwise stated, the fact that a hedge may be made with respect to property which is described in section 1221(1) (or section 1221(4)) does not mean that the actual futures are property described in either of these subsections.

Id., at p. 10. To meet the judicial exception created by Corn Products, the Supreme Court has determined that the futures contracts must be related to the acquisition of inventory

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<sup>9</sup> The Supplemental Protest, page A-21, relies on the Supreme Court's opinion in Corn Products to support the characterization of ██████████'s "hedging" losses as ordinary. However, as discussed above, we believe that opinion is limited to hedging activities in futures contracts where the contracts can be considered substitutes or surrogates for inventory.



assets, and that the contracts must be substitutes or surrogates for inventory. The judicially sanctioned GCM 17322, supra, discussed in the Corn Products opinion, and its successor, Rev. Rul. 72-179, 1971-1 C.B. 57, describe "bona fide hedging" activity consisting of inventory asset hedges. There is no mention of the type of liability hedging engaged in by [REDACTED] under the facts of this memorandum.

[REDACTED]'s use of futures contracts to protect itself from the interest rate fluctuation risks associated with financing the purchase of mortgages does not fall within the Corn Products inventory acquisition hedging exception to section 1221 because the futures contracts are not substitutes or surrogates for the mortgages to be purchased, or the pre-Corn Products bona fide hedging definitions contained in GCM 17322, as restated by Rev. Rul. 72-179.

As noted in the facts above, [REDACTED] has not asserted that the futures contracts are section 1256(e) contracts, perhaps because the contracts were not "identified" as section 1256(e) hedges as required by that section. We have not addressed the application of section 1256(e) in this memorandum; however, should that issue be raised during the course of litigation for the years in question, our response to that issue in technical advice to your office in the case of the [REDACTED] would be applicable.

#### Short Sales of Treasury Notes:

Section 1233(a) provides that gain or loss from short sales shall be considered as gain or loss from the sale or exchange of a capital asset to the extent that the property used to close the short sale constitutes a capital asset in the hands of the taxpayer. Holding period determinations are specified in sections 1233(b) and 1233(d). Additionally, section 1233(g) excepts "hedging transactions in commodity futures" from application of section 1233.

The definition of the term "short sale" is not provided in the statute; however, in Provost et al., v. United States, 269 U.S. 443 (1926), aff'g 60 Ct. Cls. 49 (1925), it was defined as a contract for the sale of shares which the seller does not own or have available for delivery at the time when, under the rules of the particular exchange involved, delivery must be made. Under this scenario, the seller will borrow the stock, security, or futures contract to be sold (via a broker) and at some later date, will be required to "cover" the sale by delivery of the replacement stock, security or futures contract. The short sale is complete upon delivery to the broker of the property necessary to replace that borrowed to make the sale. The Treasury note transactions in which [REDACTED] engaged during

██████, ██████, and ██████ appear to come within the definition of short sales under section 1233.

From the facts provided, ██████ purchases Treasury notes of the identical face amount, interest rate at maturity date as the notes sold by the broker on ██████'s behalf. Where these Treasury notes are capital assets in ██████'s hands, section 1233 requires that the gain or loss from the short sale be characterized as capital gain or loss. Certain holding period determinations are also made under sections 1233(b) and (d). Those holding period determinations are dependent upon the length of time ██████ held the property used to close the short sale. Because the holding period issues are beyond the scope of your questions to us and the facts provided, they are not discussed in this memorandum.

The Treasury notes used to close the short sale will be treated as capital assets in ██████'s hands unless they fall into one of the specific exceptions under section 1221 or section 1233(g). Section 1233(g) applies only to commodity futures used in a hedging transaction. Because ██████'s short sales involved only actual Treasury notes, section 1233(g) is inapplicable. We then must consider whether the Treasury notes fall within any of the specific exceptions to the capital asset definition contained in section 1221.

██████'s business consists of the purchase of mortgages for investment (interest) income and for resale. In addition to interest, a substantial portion of its income is derived from insurance fees, commitment fees, and servicing fees relating to the mortgages it either purchases or packages as investments for investors. It does not purchase Treasury notes or other Treasury securities for resale to the general public. Instead, it purchases these assets for resale for its own account. It does not carry out any merchandizing activities with respect to the notes, nor does it inventory them.<sup>10</sup> Under this scenario, the Treasury notes are not inventory, substitutes for inventory, or property held for sale to customers in the ordinary course of

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<sup>10</sup> ██████'s Supplemental Protest, page A-21, states that the Treasury notes and futures contracts are not ██████'s stock in trade. Furthermore, a footnote to ██████'s audited financial statement (contained in its annual report), states that as a financial institution, ██████ does not have inventory. Although we have concluded that mortgages are section 1221(1) assets (property held for sale to customers in the ordinary course of its business), this characterization does not control the characterization of other assets. The Corn Products opinion, as limited by Arkansas Best, is inapplicable to the Treasury notes because they are not substitutes or surrogates for the mortgages.

[REDACTED]'s business. Furthermore, the notes do not come within any of the other enumerated exceptions to the capital asset definition contained in section 1221.<sup>11</sup> Based on the foregoing discussion, we have concluded that gains and losses from the short sales of Treasury notes are capital gains and losses. Because the Treasury notes used to close out the short sale are capital, gain or loss from the short sale is characterized as capital pursuant to section 1233.

To summarize, the Supreme Court's repudiation of the so called "Corn Products doctrine" in its recent opinion in Arkansas Best permits ordinary characterization only for assets that are specifically excepted from the definition of the term "capital asset" as contained in section 1221, are part of a bona fide hedging activity using futures transactions (as described in the judicially sanctioned GCM 17322), or fit within the narrow application of the Corn Products case as inventory hedges that are substitutes or surrogates for inventory. We believe that [REDACTED]'s characterization of the futures contracts and short sales of Treasury notes as ordinary (hedging) transactions is not supported by section 1221, but instead relies on the "Corn Products doctrine." On the basis of the Arkansas Best decision, we conclude that the transactions are characterized as capital under section 1221. Gains and losses from the short sales of Treasury notes will therefore, be treated as capital under section 1233.

Issue 2: Whether losses from futures transactions and short sales of Treasury notes are [REDACTED]

[REDACTED]

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<sup>11</sup> 1981 amendments to section 1221 repealed the exclusion from capital gain treatment for government securities, formerly identified in section 1221(5).

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Issue 3: Whether it is permissible for [REDACTED] to report losses realized on financial interest rate futures transactions for tax purposes in a manner consistent with its method of reporting such losses for financial accounting purposes.

In its Supplemental Protest, [REDACTED] contends that [REDACTED]'s losses from "hedging" transactions are properly recognized in the year in which the transactions were closed. As discussed in the following paragraphs, we agree with [REDACTED]'s contention on this issue.

With respect to case law, there are Supreme Court cases which stand for the proposition that tax and financial accounting have different objectives, and, therefore, they will not necessarily be in conformity. In American Automobile Ass'n v. United States, 367 U.S. 687, 693 (1961), the Court stated that although a business accounting method may accord with generally accepted accounting principles and practices, this does not mean that for income tax purposes it so clearly reflects income as to be binding on the Treasury. In more forceful language in Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 542 (1979) the Court stated:

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and ... to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue .... Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

See also Frank Lyon Co. v. Commissioner, 435 U.S. 561, 577 (1978) (the characterization of a transaction for financial accounting purposes and for tax purposes need not necessarily be the same); Old Colony Railroad Co. v. Commissioner, 284 U.S.

522, 562 (1932) (the rules of accounting enforced upon a carrier by the ICC are not binding upon the Commissioner, nor may he resort to the rules of that body, made for other purposes, for the determination of tax liability).

The Service has also ruled that federal tax accounting is not controlled by regulatory accounting treatment. In Rev. Rul. 68-220, 1968-1 C.B. 194, the Federal Home Loan Bank Board regulations required that loan fees be taken into income proportionately. The ruling held that for tax purposes, the entire amount of the fees was includible in income in the year received. The regulatory treatment is not controlling for income tax purposes. Similarly, in Schuylkill Haven Trust Co. v. United States, 252 F. Supp. 557 (E.D. Pa. 1966) taxpayer claimed a loss under section 165 because the state regulatory body required the downward adjustment of certain assets. The court stated that the loss had not been realized in the form of a sale, abandonment or some other identifiable event. The bookkeeping entry did not reflect a parting with any assets. "The law is clear that accounting rules and other regulations of both state and federal regulatory bodies are not binding for the purposes of determining federal income tax consequences." Id. at 560.

Furthermore, the Service has had consistent lack of success in defending Rev. Rul. 72-114, 1972-1 C.B. 124, which imposed upon utilities a requirement that they conform their financial and tax accounting reporting if they used the meter reading and billing cycle method of accruing income for tax purposes. For example, in Public Service Co. of New Hampshire v. Commissioner, 78 T.C. 445 (1982), the court noted that the parties stipulated that the meter reading and billing cycle method of accounting is accepted in the industry and is used by a majority of public utilities. The court concluded:

[P]etitioner's method of accounting does clearly reflect income, and, therefore we hold that respondent has abused his authority by requiring petitioner to recognize the unbilled December revenue in the year of use by the customer merely because its failure to report such revenue for tax purposes did not conform with its treatment of such revenue in its books and financial statements.

Id. at 457-58.

Four years later the court unequivocally stated that the Commissioner's arguments in Orange and Rockland v. Commissioner, 86 T.C. 199 (1986), were identical to those in Public Service and that Public Service was dispositive of respondent's assertions that the cycle meter reading method of accounting

fails to clearly reflect income within section 446(b) unless there is conformity between tax and financial reporting. The court concluded again that the cycle meter reading method clearly reflects income and respondent abused his discretion by requiring income recognition of unbilled revenue merely due to the absence of conformity of such treatment between tax and financial statement purposes.

The Commissioner's section 446 powers with respect to whether a method of accounting clearly reflects income do not override the tax accounting concept of realization, whether a gain or loss has been realized and should be recognized. Cf. Schuykill, supra. Section 1001(c) provides that the entire amount of gain or loss, determined under the section, on the sale or exchange of property shall be recognized. As you note in your technical advice request, hedging case law has consistently treated the disposition of a hedging contract as a sale or exchange, an immediate realization event under section 1001. Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955); Smith v. Commissioner, 78 T.C. 350 (1982).

Also, section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year, not compensated for by insurance. Accordingly, we agree with taxpayer's argument that sections 1001(c) and 165(a) provide clear statutory authority for the current deduction of hedging losses.

In summary, we conclude that although the Commissioner may have the power to insure clear reflection of income under section 446, section 1001 determines whether or not there is income from a sale or exchange. The Commissioner's powers under section 446 will ordinarily yield to the statutory determination of when realization occurs (i.e., sections 1001(c) and 165(a)) in the sale or exchange context. When a hedge position is closed, there is a section 1001 realization event.

#### CONCLUSIONS


We have concluded that losses realized on [REDACTED]'s futures trading and short sales activity are characterized as capital rather than ordinary, based on the Supreme Court's repudiation of the "Corn Products doctrine" on which ordinary characterization would have been based under the facts presented in the memorandum. We have further concluded that because these losses are not ordinary losses, they are not [REDACTED]. Finally, we have concluded that the "hedge accounting" method used for financial accounting purposes is inappropriate for tax accounting purposes. We believe that sections 1001(c) and 165(a) provide clear statutory authority for the current deduction of losses

and current inclusion of income when the futures transactions are closed.

However, as you are well aware, the application of Arkansas Best to hedging transactions is currently being studied and evaluated at the highest levels within the Office of Chief Counsel. To date, no definitive conclusions have been reached on the characterization of liability hedging transactions using futures contracts. For this reason, we must caveat our response to Issue 1 by stating that our conclusions may change to reflect official Service position once that position has been formalized. However, our conclusion on the capital characterization of gains and losses recognized on the short sales of Treasury notes will most likely not be changed by any formal position on the application of Arkansas Best.

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